

Box 4

A RETURN OF TRADITIONAL EMERGING MARKET RISK?

Before the onset of the financial market turmoil in the summer of 2007, risk premia for emerging market assets displayed a notable decline. In part, this decline was justified by a strengthening of the debt-repayment capacities of many emerging markets and by their large current account surpluses. To some extent, however, it also reflected a disregard for traditional measures of emerging-market risk amid a global hunt for yield and abundant liquidity. Some pockets of vulnerability have persisted, for example, in countries neighbouring the EU and in some new EU Member States (see Box 2) that run considerable current account deficits. In addition, sizeable capital inflows to emerging markets may cease or contribute to macroeconomic overheating.

Among other indicators, the improvement in emerging markets' resistance to external shocks was reflected in the compression of their sovereign debt spreads. The JP Morgan Emerging Market Bond Index Global (EMBIG) reached lows of around 100 and 200 basis points for sovereign bonds rated investment and non-investment-grade respectively in June 2007. After the outbreak of the financial turmoil, spreads widened and financial markets began to progressively discriminate amongst emerging market borrowers of different credit quality. The gap between JP Morgan EMBIG spreads on investment and non-investment-grade emerging market economy bonds increased from around 100 basis points on 1 July 2007 to more than 200 basis points on 31 July 2008.

To gauge which aspect of country risk featured most prominently in this reassessment, this box examines the evolution of emerging market spreads across groups of countries that share similar vulnerabilities.¹ The countries are, therefore, ranked according to their relative positioning in

¹ The analysis includes those countries that are represented with a weight of more than 0.5% in the JP Morgan EMBIG, namely Argentina, Brazil, Chile, China, Colombia, Ecuador, Indonesia, Kazakhstan, Lebanon, Malaysia, Mexico, Panama, Peru, the Philippines, Russia, South Africa, Turkey, Ukraine, Uruguay, and Venezuela. Kazakhstan was excluded from the analysis due to a lack of data.

respect of a range of country risk measures in 2007.² These measures include traditional indicators related to the capacity to service external debt along with macroeconomic overheating, in combination with a lending boom that may lead to a disorderly adjustment. Two qualitative indicators are also considered, namely political risk and the exchange rate regime. For each measure, a weighted average JP Morgan EMBIG spread is computed for the tercile of countries with the least risky profile (first tercile), and is compared with that for countries with the riskiest profile (third tercile). The findings are presented in Chart A. From the developments between 1 July 2007 and 31 July 2008, the following observations become clear:

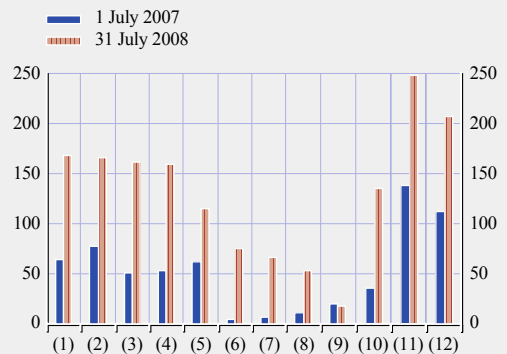
A rising discrimination between emerging market economies in the third tercile and those in the first was apparent with respect to most indicators considered. This was most notable in the case of foreign exchange reserves (expressed as a percentage of imports and short-term debt), fiscal balances and inflation, suggesting that market participants increasingly price the risk of overheating in some emerging markets. This observation is confirmed by a widening of the difference in sovereign spreads between countries with rapid GDP growth when compared to those with moderate growth. Likewise, market concerns about rapid credit growth, which may lead to imprudent lending and deteriorating credit quality, also increased.

Turning to the qualitative indicators, not surprisingly, spreads for emerging markets with a higher political risk in 2007 widened most. Furthermore, fixed exchange rate regimes were seen by market participants to be more risky than free-floating currencies, possibly reflecting concerns about the possibility of disruptive exchange rate moves, episodes of capital-flow reversals and the build-up of currency mismatches.

Summing up, the results show that traditional country risk measures have returned as a gauge of emerging market vulnerabilities for which bond investors demand a premium. In addition, concerns about rising inflationary pressures in an environment of macroeconomic overheating

Chart A Differences in JPMorgan EMBIG spreads between high and low-vulnerability emerging markets

(basis points)



- (1) Foreign exchange reserves as a share of imports of goods, services and income.
- (2) General government balance as a share of GDP.
- (3) CPI inflation.
- (4) Foreign exchange reserves as a share of short-term external debt.
- (5) External debt as a share of GDP.
- (6) Domestic credit growth.
- (7) Real GDP growth.
- (8) Current account balance as a share of GDP.
- (9) External debt as a share of exports of goods, services and income.
- (10) Exchange rate regime.
- (11) Political risk.
- (12) Rating.

Sources: IIF, IMF, JPMorgan Chase & Co., Bloomberg and ECB calculations.

Note: (1)-(9) Difference between the third tercile and the first tercile; (10) Difference between countries with some form of pegged exchange rate and those with a freely floating regime; (11) Difference between countries with a high and a low political risk; (12) Difference between countries rated investment grade and non-investment grade by at least two rating agencies.

² The country risk measures considered broadly follow those in the academic literature (see, for example, IMF, "Debt- and Reserve-Related Indicators of External Vulnerability", 2000, M. Bussiere and M. Fratzscher, "Towards A New Early Warning System of Financial Crises", *Journal of International Money and Finance*, No 25, 2006, and G. L. Kaminsky, "Crises and Sudden Stops: Evidence from International Bond and Syndicated-Loan Markets", *Bank of Japan Institute for Monetary and Economic Studies Discussion Paper Series*, 2008). An indicator of political risk was obtained from the *Economist Intelligence Unit*. It is unavailable for Lebanon, Panama, and Uruguay. The classification of exchange rate regimes follows the IMF's de facto methodology introduced in 1997.

seem to have risen. From a global financial stability viewpoint, the heightened awareness and the proper pricing of these risks are a positive development. Nevertheless, risks in some emerging markets have increased due to domestic and global factors. A disorderly adjustment in a major emerging market could have negative repercussions on the global financial system and might lead to an increase in risk aversion. However, the direct exposure of euro area banks to those emerging markets whose spreads have deteriorated most remains limited at USD 120 billion; for the remaining countries discussed, it amounts to USD 800 billion. This contrasts with total euro area bank lending of USD 2,300 billion to emerging markets, which includes exposure to EU new Member States (see Box 2).